

Earnouts: Discussion Points

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Buyer's Objectives in Using Earnouts

- Provides comfort to Buyer that the Seller is confident of the Company's future performance;
- Provides an incentive for the Seller/Operator to continue to run the business well;
- Aligns the Buyer and Seller with respect to future Company performance;
- Allows the Buyer to finance less cash;
- Maximizes the purchase price for both parties;
- Can be used to “control” Seller's future behavior with respect to non-compete and employment;

Seller's Objections in Accepting Earnouts

- How do I know I will ever see any more cash than what I receive at closing?
- Where are the “holes” in the Earnout provision? What am I missing?
- How do I know the Buyer won't run the business into the ground?
- Will the Buyer manipulate the Company's earnings to preclude me from seeing future payments?
- How should the Earnout be structured to safeguard my payments? What are the appropriate criteria to measure future performance?
- What is an appropriate time period for the Earnout?

Examples of Two Earnout Structures

- Tax treatment and Pros/Cons

- What is the appropriate criteria to drive the earnout? Revenue; earnings; operational driver (such as utilization rate, for example); time;

Most Common Structures

- Sharing of Future Earnings. Payments based on Company's future earnings as either a percentage of net income or based on minimum earnings hurdles;
- Subordinated Note. Payments include interest expense and principal payments, both of which can be based on future earnings.

Elm Street Capital Partners LLC's Preferred Earnout Structure: Subordinated Note

- The principal amount “defines” what the Seller will receive, as compared to a sharing of future earnings;
- Interest and principal payments are tied to the Company's future earnings;
- “Earnings” tends to represent EBITDA, excluding any Elm Street Capital Partners-related costs (management fee, travel costs);
- The principal amount may be adjusted upwards or downwards if the 3-year cumulative EBITDA exceeds (or fails to achieve) an agreed-upon amount;
- The maturity of the note is in the six to ten year range; allows for a senior lender to get repaid first; ensures the Seller does not compete; provides the Company with adequate time to repay the note;
- Provisions of the note are balanced; no dividends to the stockholders until the note gets repaid; no maintenance covenants.

Summary

- An earnout is a mutually beneficial tool to getting a deal done if structured appropriately;
- It maximizes the selling price for the Seller; it matches the Company's future earnings with the payments made to the Seller;
- Should not provide a financial “burden” on the Company, but should be structured as a sharing of the wealth;
- The amount of the selling price that can be paid in the form of a note can range up to 50% of the purchase price for smaller deals where financing is difficult to access;
- An earnout becomes easier for a Seller to accept as he/she gets more comfortable with the Buyer: Trust must be established between the parties with face-to-face time.